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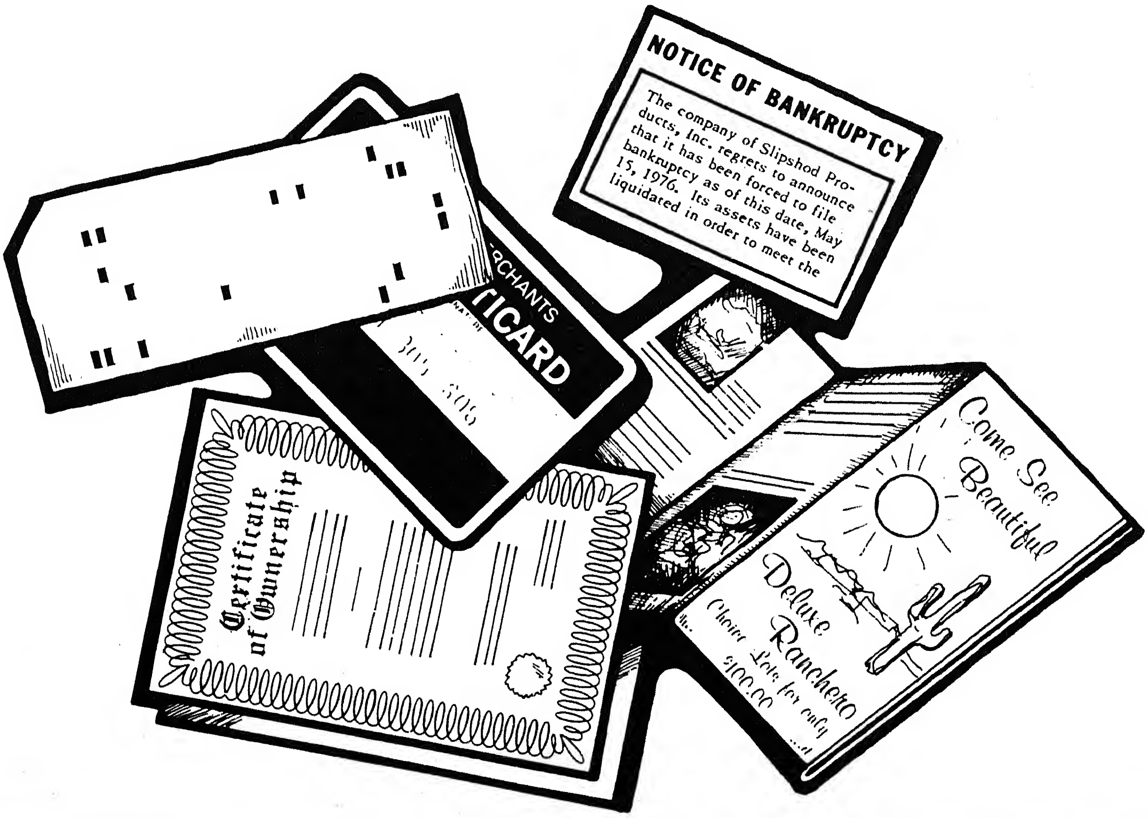
WHITE COLLAR CRIME

# EXPANDING ENFORCEMENT OPTIONS: THE SECURITIES FRAUD APPROACH

## *AN OPERATIONAL GUIDE TO WHITE COLLAR CRIME ENFORCEMENT*

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## FOREWORD AND ACKNOWLEDGMENTS

This Operational Guide is one of a series developed by the National Center on White-Collar Crime as part of the Center's program of support services to agencies engaged in the prevention, detection, investigation, and prosecution of white-collar crime and related abuses. These Operational Guides are intended for use in actual law enforcement operations, as well as training, on the theory that the best training materials are those which most respond to the day-to-day needs of users who regularly practice their skills. This series evolved parallel with, and as a part of the Center's preparation of a curriculum for training in the field of white-collar crime enforcement.

Special mention should be made of the support and encouragement of James O. Golden, Director of the Criminal Conspiracies Division of the Office of Criminal Justice Programs, Law Enforcement Assistance Administration, and of Mr. Jay Marshall who is our L.E.A.A. Project Monitor. Last, we gratefully acknowledge the invaluable support of members of the Battelle Law and Justice Study Center staff, and particularly that of Cheryl Osborn who typed our manuscripts, kept our files, and did all those things without which this series could not have been created.

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Collar Crime

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# OPERATIONAL GUIDE TO WHITE-COLLAR CRIME ENFORCEMENT

## THE NATIONAL CENTER ON WHITE-COLLAR CRIME

Herbert Edelhertz, Project Director

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## EXPANDING ENFORCEMENT OPTIONS: THE SECURITIES FRAUD APPROACH

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EXPANDING ENFORCEMENT OPTIONS: THE SECURITIES FRAUD APPROACH

by Joseph Long

TABLE OF CONTENTS

# EXPANDING ENFORCEMENT OPTIONS: THE SECURITIES FRAUD APPROACH

By Joseph C. Long

## I. INTRODUCTION

The purpose of this guide is to point out that the state securities laws are often a viable alternative to control various types of schemes which are often difficult to control through the use of more traditional civil and criminal statutes. We will attempt to accomplish this goal by first outlining the essential provisions of the securities act. We will discuss in general terms those types of activities which can be brought within the acts, what are the general characteristics of these activities which the investigator should look for, and finally how the acts can be used to control, prohibit, or punish undesirable conduct which comes within their purview. We will then undertake a case-like study of several of the current types of situations which investigators are likely to face, pointing out the various alternatives for their regulation.

Before looking at the specifics of the securities acts, some general comments are in order. The first state securities act was passed in Kansas in 1911, some twenty-two years before the federal government entered the securities regulation area with the passage of the Securities Act of 1933. The state securities acts are generally known to people who deal with them as "Blue Sky Laws." This name apparently comes from the comment of one of the Justices of the Supreme Court in an early case challenging the constitutionality of the state acts, that these acts were passed to control schemes which have no more substance than so many feet of the blue sky.

This statement highlights one of the very prevalent misunderstandings about the purposes of the state securities acts. Many people think that these acts are limited to regulating regular types of securities such as common stocks and corporate bonds traded on national securities exchanges such as

the New York Stock Exchange. While the various federal securities acts do have their focus on regulating these securities and the national markets in which they are traded, the state securities acts are largely focused toward the regulation of the irregular securities or the newly formed company.

Thus, in a very real sense, the securities acts were the first consumer protection statutes. In order to control the multitude of irregular and often fraudulent investment schemes which developed during and after World War I, the early definition of a security (which generally encompassed only the more commonly identified types of securities such as stocks, bonds, and debentures) underwent a process of evolution. As a new scheme would appear and be held not to come within the existing definition of a security, the state legislature would amend that definition by the addition of a new general term aimed specifically at controlling this new scheme. This process of evolution continued throughout the 1920's and into the early 1930's. It came to an end with the passage of the Securities Act of 1933, the definition which has become the model for the definition of a security found in most modern state acts.

As a result of this evolution, the state acts can be made applicable to a wide range of criminal and fraudulent activity. They can be made to apply to the typical business opportunity frauds currently associated with the worm farms, the work-at-home operations, and the invention or idea-development scams, as well as the more sophisticated financial frauds involving the advance-fee operations. They are also extremely helpful in controlling a wide range of Ponzi-type[1] schemes and the often fraudulent get-rich-quick operations involving the sale of race horses, diamonds, wines, coins, stamps, and art objects. As an aside here, we might point out that most of

been with us in one form or another since the begin-

its limited resources should be directed more to the oversight and regulation of the national market system, and therefore it will not become involved to any great extent with what it refers to as "the exotic securities" area, i.e., worm farms and diamond sales. Further, there is a definite trend upon the part of the Supreme Court to cut down on the number of cases being brought in federal court. One way to do so is to define narrowly rather than expansively what is a security, thus limiting access to the federal courts under the federal securities act. The state courts, on the other hand, which do not have the luxury of refusing jurisdiction and which must deal with these problems under one heading or another, have not shown the inclination to restrict the coverage of the securities acts, but have in the last ten years returned to the broad interpretation afforded these acts in the 1920's. As a result, there has developed a split in what has been considered a security under the federal and state acts. For example, in the recent case of Stanley v. Commercial Courier Service,[2] the court held that a business-opportunity scheme in the form of a franchise was not a security under federal law, but was a security under Oregon state law. Thus a word of caution: take the decisions of the federal courts and the SEC with a grain of salt. The same result need not necessarily follow under the state law!

Finally, there is another myth which needs to be dispelled. Many people, who have not dealt with the securities area before, have the mistaken impression that development and prosecution of a securities case is extremely complex, difficult, and time consuming. To be sure, certain types of securities fraud cases such as that involving the Homestake oil and gas drilling tax shelters are complicated because of the necessary effort to unravel the financial transactions involved. However, the development and prosecution of the typical business-opportunity scam for failure to register under the securities act (as will be seen in Section III) should be quite simple. The only difficult part will be recognizing that the

facts of the new scheme fit the fairly well-defined definition of a security. Again, I would emphasize that most of the current schemes are not new but merely revised versions of schemes which were held to be securities in the 1920's.

## II. WHAT IS A SECURITY?

With this general background information, let us now turn to the very important question of determining what a security is. Presently, all fifty states have securities acts of one form or another and all have been the subject of numerous court decisions. Therefore, it is difficult to talk in specifics as to what a security is under a particular state's laws. However, some 34 of the states have adopted the Uniform Securities Act and the definition of a security in this act and most other state acts is based upon the definition found in the Federal Securities Act of 1933.[3] As noted above, this definition was nothing more than a codification of the definitions found in the then existing state statutes. Thus, while it is not possible to be sure of the classification of a particular item in a particular state until the courts of that state have ruled on it, educated guesses can be formulated.

The obvious starting point is the statutory definition itself which reads:

> "Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract, voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease; or, in general any interest or instrument commonly known as a security.

While the investigator or prosecutor may come into contact with cases involving many of these items over an extended career, there are only three that will be used on a recurring basis. These are: (1) evidence of indebtedness; (2) investment contract; and (3) certificate of interest or participation

in any profit-sharing agreement. Let us consider each of these in turn.

## A. EVIDENCE OF INDEBTEDNESS

The presently accepted definition for evidence of indebtedness comes from a federal criminal case where the court said:

> The term 'evidence of indebtedness' is not limited to a promissory note or other simple acknowledgement of a debt owing and is held to include all contractual obligations to pay in the future for consideration presently received.[5]

Stripped to its essentials this quotation says that in order for the court to find evidence of indebtedness, evidence will have to be presented (1) that the victim gave the defendant some consideration and (2) that the consideration was given in exchange for the defendant's promise to pay money at some time in the future. The consideration given by the victim does not have to, but usually will, be in the form of a cash payment. Payment in kind by delivery of goods would be sufficient, as would performing services for the defendant or some third party designated by him. While it is not totally clear, it is believed, however, that the promise of the defendant must be to pay money rather than to deliver goods or services. The transaction must be carefully analyzed to determine the true nature of the defendant's obligation. Thus in commodity option cases, the defendant's contractual obligation was to buy or sell the underlying commodity futures. Investigation revealed that in less than 1% of the cases were any futures actually changing hands. The option seller was merely paying the purchaser in cash the difference between the futures price and the option contract price, i.e., the purchaser's profit on the transaction. The courts had little trouble holding this to be an evidence of indebtedness in reality, if not in form.[6]

Two further comments are in order about evidences of indebtedness. Most people tend to think of evidences of indebtedness involving fixed sums of money, i.e., the promise to pay $1,000.00. While many evidences of indebtedness do

represent fixed promises to pay, this characteristic is not a requirement of this form of security, and the obligation may be a variable one or one fixed by reference to some measure beyond the control of either the promoter or the investor. Thus in the commodity option scam, the promoter promised to pay the difference between the contract price of the commodity under the option and the market price of the commodity at the time of exercise of the option. The price obviously varied from day to day and was determined by factors beyond the control of either the option dealer or the investor.

Second, the promise to pay does not have to be an absolute promise to pay, but may be a conditional one based upon the occurrence of a particular event. Again, in the case of the commodity option scam, the seller of the option only promised to pay if the underlying commodity moved in price so that there was a profit in the investor's option. As will be seen when we consider the case studies in Section IV, the concept of evidence of indebtedness has been very useful in dealing with the advance-fee schemes which are presently active in many states.

## B. INVESTMENT CONTRACTS

The category of investment contracts is the most commonly used of the general categories within the definition of a security. It is the one which will be used most frequently to control the business-opportunity schemes and the get-rich-quick operations. There are three fairly well-recognized tests for determining the existence of an investment contract. These are: (1) the *Howey* test; (2) the risk-capital test; and (3) the combined risk-capital-*Howey* test. Let us consider each of these briefly.

### 1. The Howey Test

The *Howey* test is taken from the case of *SEC v. W.J. Howey* and is the exclusive test under federal law for determining what is an investment contract. It is also probably the test most widely used at the state level as well, although many

states are beginning to recognize the other tests as alternative tests. This test states:

> (A)n investment contract . . . means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.

Most authorities agree that there are four parts to this test: (a) the investment of money; (b) in a common enterprise; (c) with the expectation of a profit; and (d) that this profit will be realized through the efforts of someone other than the investor.

(a) Investment of Money

If we analyze these tests and put them into plain language, it will be seen that none are difficult to understand, or in most cases, prove. Item one, the investment of money, merely means that the victim is going to have to contribute some consideration for his right to take part in the scheme. Normally this payment will take the form of a cash payment to the promoter-defendant. However, it does not have to. The consideration may take the form of payment in goods or services so long as the promoter has bargained for them. Thus, in one of the Glenn Turner cases, discussed in more detail in Section IV, the court held that the required attendance at a sales promotion school constituted services bargained for and was part of the investor's contribution for the right to participate in the plan.[8] Nor does the fact that the investor receives merchandise in return for his payment prevent the payment being an investment in an investment contract. In most cases, the merchandise does not have a true fair market value anywhere close to the amount charged. Thus in the Hawaiian Market Center scheme, the investor received a sewing machine, pots and pans, or a vacuum cleaner, all valued at about $50 for his $350 investment.[9] Further, it is clear that receipt of the overpriced merchandise is not the motivating factor in the victim paying the money. He is paying to participate in the scheme.

In any event, the securities acts will normally have a provision which indicates that when a security is given in conjunction with another security or other goods, there is a conclusive presumption that part of the consideration goes for the purchase of the security.[10] Thus, in the 1930's, cereal and cigarette companies hit upon the idea of distributing fractional shares of their stock as prizes in the cereal boxes and cigarette cartons. It was determined that a person bought the stock when he paid for the cereal or cigarettes.

Further, it was once believed that this consideration would have to go to the promoter or one of his cronies. However, a recent case has indicated that this is not so. In that case, an investor entered into an agreement with Montgomery Ward to operate an "associated store" in which he would sell Ward's goods. Montgomery Ward did not require the investor to pay a fee in the form of a franchise fee for the right to become an associated store nor did it require the investor to buy from it the equipment and fixtures necessary to set up the store. The investor, however, did have to expend substantial sums with others in order to be in a position to sell Ward's goods. The court held the payment to third parties was an investment in the common enterprise (the enterprise being the selling of Montgomery Ward's goods which both Ward and the investor had a common interest in doing) because while the payment did not go directly to Ward, it inured to Ward's benefit.[11]

(b) <u>Common Enterprise</u>

There has been substantial confusion by the courts as to what is the proper meaning of the second item, a common enterprise. However, several points are clear. Common enterprise does not mean that there has to be a separate legal entity or that the investor gets an ownership interest in the enterprise. Thus, in the Hawaiian Market Center series of cases, the investor did not receive an ownership interest in the department store corporation, he received merely the right to receive certain payments. In its simplest form, a common

enterprise would seem to be nothing more than two people, one an investor or victim and the other the promoter-defendant, joining together to accomplish a common goal. The goal may be, as in the Montgomery Ward case discussed above, the selling of goods for the mutual profit of both. Or the goal may be the making of a profit solely for the investor, with the promoter being paid a fee for his services.

The investigator or prosecutor can avoid all the legal confusion surrounding the concept of common enterprise by seeing that he has evidence to show two things. First, he should be prepared to show that two or more investors have joined with the promoter to accomplish a profit goal common to all of them. This avoids the claim supported by some courts that a common enterprise cannot consist merely of one investor and the promoter. Further, the profit goal must be common to all investors. Thus, it is not sufficient in the view of some courts for the promoter to have a series of discretionary trading accounts with a number of people where the goal of the promoter is to make a profit for each. The profit goal in such cases would not be common to all, but would be an individual goal of each investor.

Further, the accomplishment of this profit goal must require some positive activity on the part of the promoter or some third person. Thus the securities laws do not regulate those schemes which are totally passive in nature and depend solely for their profit on general inflation or unrelated development. Thus, the purchase of a piece of land on which no development was intended or where the promoters did not intend coordinated development of the surrounding land normally would not constitute an investment contract. In the case of the normal business-opportunity scheme, this is relatively easy to find because the promoter will be involved in manufacturing or marketing a product or service. Thus in the case of cattle-feeding programs, the investor furnishes the capital to buy the cattle and the promoter cares for, feeds, and usually markets the fat cattle.

In the case of the get-rich-quick scheme involving the sale of diamonds, stamps, coins, or art objects, this positive activity on the part of the promoter may be found in either of two ways. First, the promoter will often offer to help the investor market the item purchased when it comes time to realize on the investment. In other cases, the necessary activity can be found by the promoter exercising his special training or skill to determine which items to invest in because they will appreciate at a faster rate than other items of the class. Thus the stamp or coin dealer exercises his special knowledge of the industry to pick the rarer coins or stamps that will appreciate faster than coins or stamps as a general class.

(c) Expectation of a Profit

Much of the confusion surrounding the third element, the expectation of a profit, has been solved by a recent Supreme Court decision.[12] First, the court concluded that the "profit" here would have to be a tangible economic benefit such as money received rather than an intangible benefit such as the right to use a golf course and club house. Second, the Court held that this "profit" would have to take one of two forms, either money paid for the use of the capital invested, as in the case of the payment of interest or dividends, or increased value in the form of capital appreciation, i.e., increased market value in the case of stamps, coins, and the like, or the calf in the case of a cow-and-calf investment operation. The Court specifically rejected the idea that a saving of costs or a loss would qualify as a profit. Thus. the ability to rent an apartment below existing market prices did not constitute a "profit." While it is still too early to be sure, it is believed that the state courts probably will follow the lead of the Supreme Court and place similar restrictions on the concept of "profits" under the blue sky acts.

A number of other comments are appropriate about this element. All that is required is that the investment by the victim be <u>induced</u> by the expectation of the profit as defined

above. The fact that the profit does not materialize is totally irrelevant. Second, the expectation of the profit to the investor is not necessary to the promoter or common enterprise in which the investment is made. Thus a number of courts were incorrect when they held that the door-to-door referral schemes[13]--where the person making the referral received a cash payment or credit against a product purchased for every person referred who allowed the salesman to demonstrate the product regardless of whether a sale was made or not--did not involve investment contracts. There, the person making the referral expected a profit regardless of whether the company selling the product did or not. This idea becomes very important in the case of the Ponzi scheme where the promoter pays previous investors out of the money received from new investors and the enterprise frequently never turns a profit from the activity it was organized to engage in.

(d) Profit Solely Through the Efforts of Others

The key to understanding the fourth element of the Howey test (i.e., the profits to come solely through the efforts of others) is to understand what is meant by the word "efforts" and to relate that concept to the purpose for which the securities acts were enacted. It is now generally understood that the concept of "efforts" here means management efforts or the ability to make the decisions which will determine whether the investment is successful and the profit realized, or a failure, where the profit is not attained and possibly the investment itself is lost. If the investor does not have the right to participate in these managerial decisions, it is unimportant whether he is required to perform physical efforts for the enterprise. Thus in the Hawaiian Market membership cases, if the investor does not enjoy the right to participate in the management decisions dealing with such things as merchandising, pricing, financial policy, or store operation, the things that will determine whether he receives the promised profit he has been led to expect, then it is totally unimportant whether the

membership agreement provides that he will make himself available to sweep out the store on six evenings a year. He does not share in the critical management decisions, and therefore his investment is an investment contract and a security, despite the fact that he performs some physical labor for the enterprise.

Treating the concept of "efforts" in this way brings the definition of investment contracts in line with the general purpose of the securities acts. These acts were not enacted to regulate all investments, only those investments where the investor remains passive, turning his capital over to another to employ. In such cases, the regulation provisions are geared to seeing that the investor has sufficient information about the project in which he is asked to invest and the people to whom he is entrusting his capital to make an intelligent investment decision. If he has the right to actively participate in the management, he does not need the protection of the securities acts because he is in a position to control for himself the destiny of his investment and is not dependent upon the skill and judgment of others.

Having said this, two points should be quickly added. This right to participate in the management of the enterprise must be derived from the investment itself and not from any employment position which the investor might have with the enterprise. Thus, common stock in the hands of the corporate president does not cease to be a security merely because it is held by the person, who because of his employment position is making the managerial decisions for the enterprise. Second, the right to exercise this management right must also exist in fact as well as in form. Thus a general partnership interest is not a security when the general partner actually has the right to participate in management whether that right is exercised or not. On the other hand, a general partnership interest would be a security where the general partner has either formally or by informal agreement agreed that the management of the partnership would be left to a single managing partner or group of managing partners.

(i) The Risk-Capital Test

As an alternative to the Howey test, the California Supreme Court developed what has been referred to as the "risk-capital" test. The test first appeared in a 1961 case where the defendants had attempted to organize a country club for profit. They had gone out and secured an option on a piece of land on which they proposed to build a golf course and club house. In order to raise the funds necessary to acquire the land and complete construction, the promoters were selling memberships in the club. The membership did not give the holder a proprietary interest in the club or its assets but merely the right to use the club facilities conditioned upon the further payment of monthly dues. The court concluded that these membership agreements were securities saying:

> We have nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of the club membership will materialize.[14]

The first thing we need to do under this test is understand what is meant by risk capital. Several different interpretations are possible and the courts have not as yet solved the ambiguity which surrounds this term. However, most authorities now believe that the term "risk capital" should be equated with the concept of the economic capital which is placed subject to the risk of loss through the operation of the scheme in question. This would include the equity capital of the scheme raised through the sale of common and preferred stock or partnership interests. It would also include debt financing in the form of promissory notes, bonds and debentures. Bur further, it would include payments such as the above-described memberships and in certain cases franchise fees which do not represent an ownership interest nor a true debt interest because repayment is not one of the conditions of the agreement, but which are necessary if the scheme or enterprise is to have a viable chance of success.

The test itself is generally considered to have three elements: (1) an investment; (2) in the risk capital of an enterprise; and (3) the expectation of a benefit. The first of these can be quickly disposed of. The concept of investment here is identical to the concept of investment developed above under the Howey test.

However, the concept of expectation of a benefit is not the same as the expectation of a "profit" as used in the Howey test. It should be apparent that the membership interests involved here would not be the type of tangible payment for the use of the money or capital appreciation contemplated by the Howey concept of "profit." Here the test seems to contemplate any benefit tangible or intangible which the investor seeks in exchange for his money. This broader concept of "benefit" has been quite useful in helping to regulate schemes such as those involving advanced hotel reservations over long periods, vacation licenses, and condominium time-sharing agreements.

The major advantage of the "risk capital" definition, other than the extended concept of benefit just noted, is that it frees the courts from the constrictions of the decisions under the Howey test dealing with "common enterprise" and "solely through the efforts of others."

In turn, it also creates its own problem for the investigator and prosecutor. It is clear that the investigator will have to show that the money or consideration given by the victim actually goes into the risk capital of the scheme. It is presently believed that this can be accomplished by either of two methods. First it can be done by tracing the money into the bank account of th scheme and then show that funds from that account were actually used to pay the bills incurred in the scheme, i.e., used to pay salaries, utilities, building rent and the like. This is probably the easiest and most direct method. In the alternative, it may be possible to establish the same thing by showing that the scheme could not have operated without this fund. But for the money taken in, the business could not have continued to operate, i.e., the

gross expenses of the scheme exceed the entire capital, borrowing, and profits of the business, and the business would have been bankrupt without the funds provided by the victim.

This test has not been widely accepted outside of the states on the West Coast and has in certain cases been limited to businesses which are not yet in operation. Thus recently an Oregon court refused to apply the test to a travel club selling memberships in the state where it was clear that the club could not continue to fulfill its obligations to make the flights without the additional influx of capital, but had already offered some flights. The court held that the test was limited to "initial-risk capital."[15]

(ii) <u>The Combined Howey-Risk-Capital Test</u>

Probably the best definition of an investment contract and the one which will be most widely used, at least at the state level, in coming years is the combined risk-capital and <u>Howey</u> test first formulated by the court in <u>State v. Hawaii Market Center, Inc</u>. The court said:

> (A)n investment contrct is created whenever:
> (1) An offeree furnishes initial value to an offeror, and
> (2) A portion of this initial value is subjected to the risks of the enterprise, and
> (3) The furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
> (4) The offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.[16]

Again, item one of this test is nothing more than the investment concept of the <u>Howey</u> test. Item two picks up the concept developed above from the risk-capital test rather than the more restrictive "profits" concept found in the <u>Howey</u> test. Finally, item four makes explicit the "efforts" concept developed by the case law under the <u>Howey</u> test, removing any doubt

that physical efforts are unimportant and that the key is the ability to share in the make-or-break decision of the investment.

C. <u>PROFIT-SHARING PLANS</u>

The last of the general categories of securities that we want to talk a moment about is the profit-sharing plan. In recent years, this category has largely been absorbed by the concept of investment contracts. Thus most of the courts simply apply the tests developed above, i.e., the <u>Howey</u>, risk-capital, or combined risk-capital-<u>Howey</u> test to determine whether something is a profit-sharing plan. In certain cases where the court was bound by precedent to follow the <u>Howey</u> test for investment contracts, the court would call the scheme a profit-sharing plan and apply one of the alternative tests. The general value of this item as a separate item within the definition lies in the fact that it normally will have some meaning to laymen and people not familiar with the securities acts. Thus, if I were to ask you what a profit-sharing plan was, you would have a fairly accurate idea without any knowledge of the securities act. On the other hand, I doubt if I had asked you the same question about investment contracts before you read the previous section that you would have had much idea what I was looking for. The following ad, which appeared in a Florida newspaper a number of years ago, is the best illustration of the point of a profit-sharing plan I have found:

"Profits 30---40---50%"

> Private investors wanted now to share with responsible grower in rich Everglades Vegetable Syndicate. Another fabulous planting of Golden Bantam Table Corn for luxury Eastern market now starting. Invest $1,000; $5,000; $10,000 for about four months. Capital repaid first out of crop sales--Profits then divided with the Grower. See us for details.

## III. DESIRABILITY OF USING THE SECURITIES ACTS

With this understanding of what a security is, we can now turn our attention to considering why the securities acts are a desirable alternative to more conventional statutes for the regulation, prohibition, and punishment of certain types of business-opportunity and other get-rich-quick schemes.

Often it is more important to make the public aware of these types of schemes and to prevent further loss than it is to criminally prosecute the perpetrators after the fact. The securities commissioner may make investigations of suspected violations and may publish information concerning such violations which he finds as a result of such investigations.[17] Further on a summary ex parte basis, the securities commissioner may issue a cease and desist order instructing the offenders to stop the sales of the schemes if they constitute a violation of the securities act.[18] These cease and desist orders can be given wide publicity, and therefore are an ideal means of alerting the general public that a particular scam is operating in the state. Finally, the Uniform Securities Act empowers the securities commissioner to secure a civil injunction against further violation of the Act.[19] This can often be done on an ex parte basis as long as a formal adversary hearing is provided at a subsequent date. Thus the act provides an immediate way to stop conduct pending the development of a criminal prosecution under either the securities act or more traditional criminal statutes.

The securities acts also provide an easy means to criminally prosecute persons involved in business-opportunity and get-rich-quick operations. There are essentially three types of prosecutions which can be brought under the securities act: (1) prosecution for failure to register the securities offered or sold; (2) prosecution of the person selling the securities for failing to register as a securities agent or dealer; and (3) prosecution for securities-fraud violations. Each of these three crimes constitutes a felony offense in most states, punishable by substantial jail terms and fines. Further, the sentences can often be probated upon the condition that the person

convicted make restitution to his victims. Recently a Texas prosecuting attorney received a life sentence on a securities conviction under the habitual criminal statute. Let us consider each of these types of securities prosecutions in turn.

A. Non-registration Violations

A non-registration violation of the securities act is a very simple and easy criminal violation to allege and prove. First, it must be established that there was an offer or sale of the item in question. Note that a mere offer is sufficient; the transaction does not have to be completed. Further, while we can not go into detail in this limited guide, it should be kept in mind that the definition of a "sale" under the securities acts is very broad and covers any attempt to dispose of a security for value.[20] Likewise, it should be remembered that a local state's statute will attach if the offer to sell the security is made in the state even if the sale is completed in another state.[21] Normally the element of offer or sale can be established by having one or more of the victims testify as to what they were offered, where, and by whom.

Second, the state will have to prove that the thing sold was a security. This will present no major problem if the security in question is a regular security of the stock or bond type. However, if the security is of the irregular type, i.e., evidences of indebtedness, investment contracts, or profit-sharing plans, as discussed in Section II, then the problem will be more difficult. There are some cases which have indicated that the determination of whether the item is a security is a question of law for the court to decide.[22] Consider that the safer approach may be to have the court determine which is the appropriate test, i.e., the risk-capital, Howey, or combined risk-capital-Howey test, and then to allow the jury under proper instruction to find the necessary facts to fit each element of the test adopted. In this regard it is the practice of some prosecutors to use expert witnesses to give their professional opinion as to whether the item in question

is a security. This practice has never been ruled on by an appellate court (to the author's knowledge), but is believed to be a sound practice.

Finally, the prosecution will have to establish that the securities in question have not been registered. The simplest way to accomplish this is to have the state securities commissioner or the person in his office who is designated the custodian of the office records to testify that he has searched the records of the office and finds no registration for the securities. In some cases, this may be accomplished without testimony by a certificate from the securities commissioner.

The important thing here is what the prosecutor does <u>not</u> have to prove: he does not have to negate the existence of an exemption from the registration requirement. The Uniform Act specifically makes this a matter of affirmative defense by the defendant.[23] Placing the burden on the defendant has been held constitutional even in a criminal case. However, it appears to be the consensus that once the defendant legitimately presents some evidence that an exemption from registration might be available, then the prosecution has the ultimate burden of proof. However, in most business-opportunity or get-rich-quick schemes, there will be no attempt to comply with an exemption because the defendant probably will not realize that he is selling a security or that registration or exemption is necessary.

This leads to the second major thing that the prosecution does not need to prove. While the criminal provision of the securities act talks in terms of a "willful" violation, this has been interpreted by a majority of states merely to require that the defendant do a volitional act, i.e., that he voluntarily sell something. Thus for a conviction here it is not necessary to show that the defendant knew what he was selling was a security or that the security needed to be registered. Further it has been held in a number of cases[24] that advice of counsel is not a defense, nor is it a defense that the defendant consulted the state securities commissioner and was told that the items sold were not securities!

## B. Non-registration as an Agent or Broker-Dealer

The Uniform Act requires all agents and broker-dealers to register. A broker-dealer is defined as a person or firm who engages in the business of effecting transactions in securities for others or in his or its own behalf. An agent is defined as a person who works for a broker-dealer or an issuer directly selling securities. The agents of broker-dealers are often referred to as registered representatives. In most cases where the securities have not been registered, the people selling them do not bother to register either. Again, prosecution for non-registration as an agent or broker-dealer is an easy case to prove. As with a non-registration charge, the state will have to prove that an offer or sale of an item was made by the defendant and that the item was a security. Then the state will have to prove by direct testimony or certificate that the individual defendant was not registered as either an agent or broker-dealer with the state securities commission. Again, it is no defense to claim that the seller did not know that what he sold was a security or that registration as an agent or broker-dealer was required. The prosecutor should stand ready to rebut any evidence offered as to the availability of an exemption for the securities because the definition of agent forgives agent registration under the Act in certain cases involving exempt transactions.

## C. Securities Fraud Prosecutions

Since non-registration and non-registration as an agent or broker-dealer are technical violations of the Act and it may be difficult to get a jury to convict, these charges are often joined with charges of securities fraud. The Uniform Act recognizes three different types of securities fraud: (1) the employment of any device, scheme, or artifice to defraud; (2) the making of any untrue statement of a material fact or the omission to state a material fact; or (3) the engagement in any act, practice, or course of business which operates or would operate as a fraud or deceit.[25] While these frauds may

be alleged separately, normally they are alleged in the alternative within the same count and little effort is made at trial to distinguish whether the proven conduct comes within (1), (2), or (3). Further it should be obvious that certain conduct may fit into more than one of the categories.

A recent New York case provides us with an example of conduct which might well come within either (1) or (3). In this case, a number of specialists were convicted of entering fictitious trades in securities options on the American Stock Exchange. These trades never took place. The specialists would simply make up the trades and report them for publication on the tickertape. The American Exchange is in direct competition with the more established Chicago Board of Options Exchange (CBOE) for business in the trading of securities options. The specialists indicated that they did not intend to defraud anyone by the false trades, but merely wanted to show a great volume of trading on their exchange so that their options would be more appealing and could compete better with the CBOE options.

Probably the easiest of the three categories to prove is the second. Here all that is necessary is to show that the person who is charged either directly or indirectly (i.e., he told the salesman working under him who told the purchaser) made a false statement or omitted to tell the purchaser material information. The Supreme Court has defined a material piece of information as something which there is a substantial likelihood a reasonable person would consider important in deciding whether to purchase the security or not. Note that this does not mean that had the person known this information or that the statement made was false, that he would not have bought the security; merely, that he would have given some weight to the information in reaching his decision.

The major advantage in using the securities fraud provisions rather than laying the allegations under the more general criminal-fraud statutes, such as the mail-fraud statute or fraud by deception, lies in what need not be proven under the securities act. It is clear that it is not necessary under the

securities act to show that the victim was actually deceived by the conduct alleged.[26] As to the scienter requirement, the courts are in some confusion. It appears that the majority of courts will not require scienter in the common law sense of intent to defraud even though the statute talks in terms of a "willful" violation. The majority of courts have interpreted "willful" as used here to mean "knowing" conduct. A case can be made for saying that "knowing" here should be treated the same way as "knowing" is under the non-registration violations, i.e., nothing more than a volitional act. However at present, the courts appear to require that the defendant not only know that he made a statement or omitted to give the buyer information, but also that he knew that the statement was false or at least that he was reckless in not determining the truth or falsity of the statement or that he knew or was reckless in not determining that the statement made was only a half-truth because he did not add additional information. Even with these restrictions, proof of a securities fraud case is much less difficult than proof of an offense under the general criminal-fraud statutes.

## IV. CASE STUDIES

With this general background of what is a security and how the securities act can be a useful alternative to more traditional criminal statutes, let us now consider a series of case studies presenting schemes similar to those you are most likely to encounter.

### A. Case A--The Pyramid Sales Scheme

The prospect pays $2,000 for his supervisorship for which he receives $2,500 in retail value products plus some training and assorted services. The supervisor who sold the position received a 25% commission or $500. Also, the third-level distributor received his 10% override of $200. If the distributor had sold the supervisorship, he would have received the entire $700. To become a distributor cost $5,000. If he were already

a supervisor, this would cost an additional $3,000, of which the referring distributor would receive $1,950. Since each supervisor had to replace himself before moving up, the distributor could count on another $200 override from the new supervisor's initial payment

Potential investors are recruited at organizational meetings often called "opportunity meetings." Friends, relatives, and common strangers are approached and asked if they would like to earn $50,000 a year, or through similar baiting techniques, their interest aroused. They are then invited to the meeting to hear more. Prior to the meeting no other details are disclosed. The meetings themselves are run by rehearsed professionals who adhere strictly to a prepared script. The meetings are conducted in a revival atmosphere of enthusiasm and high-pressure salesmanship. A typical meeting will follow a format which first shows how much money the average retailer will make per year. The figure $8,000 has been used. Then the meeting discusses the large amounts which can be made on sales overrides by building a sales force. The impression is left that it is not difficult to build such a sales force and that a supervisor can make over $17,000 a year in this manner and a distributor can earn more than $50,000 from such retail sales. Finally, the meeting turns to the commissions which can be made from soliciting new distributors. It is pointed out that by bringing in just one new distributor a month a person can add as much as $36,000 per year in commissions on distributorships. Thus the pitch is that for a mere investment of $2,000 to $5,000 the investor can buy a job which will earn him as much as $100,000 per year.

1. <u>Discussion</u>

It should be obvious that this case history is based on the Glenn Turner "Koscot" and "Dare to Be Great" operations. These operations were subjected to litigation in a large number of cases, both reported and unreported,[27] on a multitude of theories. Let us consider each of these briefly.

(a) State Consumer Protection or Deceptive Advertising Statutes

Two reported cases sought to control Koscot on the basis of the state consumer protection or deceptive advertising statutes. People ex rel. Kelley v. Koscot Interplanetary, Inc., 195 N.W. 2d 43 (Mich. Ap. 1972) and Kugler v. Koscot Interplanetary, Inc., 293 A2d 682 (N.J. Super Ct., Ch., 1972). In both cases the state attorney general was able to secure an injunction against further sales. Usually the basis for the injunctions under these statutes were the claims made at the opportunity meeting regarding potential income which the investor could make selling the product or the distributorships. There is no question that these representations had no factual basis, as the Turner operations had no factual experience on which to base such claims. They were clearly calculated to deceive the prospects and falsely impress them with the fictitious experience of preceding distributors.

(b) False Pretenses Statutes

The criminal counterpart to the consumer protection or deceptive advertising statutes would be prosecution for obtaining money under false pretenses. To the author's knowledge, none of the Turner enterprises or employees were ever convicted under these statutes. The following summary of the problems under these statutes from a recent issue of the Economic Crime Digest,[28] I think illustrates why:

> State courts have been relatively consistent in their construction of false pretenses statutes. A conviction for this offense requires proof of an intent to defraud, a misrepresentation of past or existing fact, reliance on the misrepresentations by the victim, and the transfer of property and title. Specifically, a prosecutor must establish that the accused possessed, at the time of the offense, an intent to acquire the property of another by means of a false representation. The misrepresentation must concern a material fact; (and) in most jurisdictions . . . the misrepresentation must involve a past or existing fact.

This is a tall order. As the Digest goes on to say, most prosecutors have had difficulty with establishing the intent to defraud and the falsity of the material representations.

Further, it would seem that the representations in the Koscot situations often involve further misrepresentations and omissions which are not covered by these statutes. The blatant omission, as the Pennsylvania court noted in Commonwealth ex rel. Speaker v. Koscot, No. C-2603-70 (C.P. Erie County, Pa. 1970), was that no one in Pennsylvania had earned the figures set out in the sales presentation! The Digest also notes that many of these cases involve obligations for continuing performance by the promoters for an appreciable time into the future. Thus the victims do not realize for a long period that they have been victimized. In such cases, the defendants are all too often long gone.

(c) Lottery Statutes or Referral Sales Statutes

Another method used to control the Turner enterprises was the lottery or referral sales statutes. In State ex rel. Turner v. Koscot Interplanetary, Inc., 191 N.W. 2d 624 (Ia. 1971), the attorney general was successful in securing an injunction under the Iowa statute which prohibited referral sales altogether. In State ex rel. Kelley v. Koscot Interplanetary, 195 N.W. 2d 43 (Mich. App. 1972), the attorney general was successful in having Koscot declared to be a lottery under the Michigan lottery statute. The theory here is that the Koscot distributorships constitute an endless chain and therefore the operation is similar to a gigantic chain letter. The basic elements of a lottery are generally considered to be consideration, prize, and chance. The courts have had no difficulty in finding the first two of these. The payments for joining the marketing plan is the consideration, and the hope of receiving commissions through the sponsoring of others is the prize. But several courts have had difficulty finding the necessary third element, that of chance.

(d) Unfair Business practices (State Anti-trust Acts)

The court in Kugler v. Koscot Interplanetary, Inc., 293 A. 2d 682 (N.J. Super., Ch. 1972) found a violation of the state

anti-trust act. The conclusion stemmed from the fact that the new distributor as part of his contract agreed to abide by all rules and regulations promulgated by Koscot. These regulations among other things stated that: (1) products could only be bought from the company or the sponsoring supervisor or distributor; (2) the retail resales were limited to door-to-door selling; (3) all retail sales had to be made at prices set by the company; (4) no advertising could be done without prior company approval; (5) no transfer from one distributor to another distributor without prior written approval of all persons in the distributorship left who were senior to the person transferring; and (6) no person could have a financial interest in more than one distributorship nor could any distributor enter into a profit-sharing agreement with others in his organization. All these items have been considered to be "vertical" restraints on trade and violations of the state and federal anti-trust acts. Of particular interest here is that most state anti-trust acts contain provisions indicating that judicial interpretations of the federal act provisions will be controlling.

(e) Other Theories

A number of minor theories have also been used against the Turner enterprises. Several states got injunctions against them because the corporation had not qualified to do business in the state. Another state used its statute controlling proprietary schools to get an injuunction against a similar operation when the enterprise did not register and post the required bond. North Carolina stopped one of the Turner enterprises on the basis that the employees encouraged potential investors to borrow money and lie to financial institutions as to the purpose for which the money was intended. See State ex rel. Morgan v. Dare to be Great, (Super. Ct. Wake County, N.C. March 27, 1972), *aff'd* No. 7210SC517 (Ct. App. July 12, 1972). This action constituted common law fraud and also would constitute a violation of federal criminal law dealing with bank loan applications. See 18 U.S.C. §1014 (1978).

(f) Securities Acts

While there are a number of theories which have been used with varying degrees of effectiveness against this type of operation, by far the most effective has been the securities act. Both state and federal courts held that the Turner sales programs constituted investment contracts. See e.g., SEC v. Glenn Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973); State ex rel. Park v. Glenn Turner Enterprises, Inc., (1971-78 transfer binder) Blue Sky L. Rep. ¶71,023 (Idaho Dist, Ct. 1972). Clearly the payment of the $2,000 to $5,000 to become either a distributor or supervisor was an investment of money. This money went in part at least to finance the continued presentation of the "opportunity meets." Evidence established that money from the sale of the distributorships was used for hall rental, fees for the persons presenting such meetings, and, in the case of Dare to Be Great, for the supplies and materials given the investor. Thus the risk-capital test was met. Further, the common enterprise here under Howey test was the continued sale of distributorships and product. Both Glenn Turner and the investor had this as their common goal. Obviously there was an expectation of a profit or benefit here in the form of continuing commissions from the new distributors and supervisors introduced into the chain. In most cases, anticipation of these commissions rather than the commissions on the sale of the product was the factor inducing investment in the plan. Finally, it is clear that the individual distributor or supervisor did not share in the management decisions of the opportunity meeting. These were conducted by professionals hired by the Turner organization who were required slavishly to follow careful prepared texts generated by the Turner organization. The only efforts supplied by the supervisor or distributor was to invite people to the opportunity meeting and to get their signature on the contract once they had been convinced to buy by the professionals at the opportunity meeting.

Turner did not attempt to register these securities with either the SEC or any of the state securities commissions.

Thus it would have been easy to get a criminal conviction for failure to register. Likewise no one in the organization attempted to register as an agent or broker-dealer. Again, criminal prosecution for this violation would have been very easy. Finally, the same false statements and omissions which were discussed under Section (b), dealing with obtaining money under false pretenses, would clearly have supported a conviction for securities fraud without having to prove either reliance by the victim or intent to defraud.

As a postscript, it should be noted that some 66,000 people invested between $2,000 and $5,000 in Turner's two basic enterprises, Koscot and Dare to Be Great. Few have received any recovery of their money. Glenn was able to avoid criminal prosecution at both the state and federal levels, and the March 27, 1978 issue of Business Week indicates that Turner is back in business with the same old selling scheme under the name of Nature's World.

B. Case B--The Business Opportunity Scheme

Bonanza Productions Company offered to the general public distributorships with accompanying "Purchase Order and/or Manufacturing Agreements" for $7,000. The distributorship entitled the investor to sell Bonanza, at a fixed price, 1,000 completed eight-track cassettes a week. Under the agreement, Bonanza agreed to furnish the investor with uncut reels of recording tape which had been prerecorded with materials selected by Bonanza; the plastic parts for cassette housings; and other supplies and tools necessary to cut the tape, assemble the cassettes, and package the finished product. The investor-distributor for his part agreed to take the uncut reels of tape, cut them to their proper length, assemble the cassettes from the parts supplied, inset the cut tape, and seal and package the finished cassette. This process was to be accomplished only under Bonanza-authorized techniques, following all Bonanza quality controls and production guidelines. The distributor agreement provided that the investor would only assemble tapes

for Bonanza and that Bonanza would assume sole responsibility for marketing and shipping the distributor's cassettes under its own brand name.

1. Discussion

The above facts present a rather typical business-opportunity scheme. If we were to replace the cassette assembly with the sale and resale of worms, we would have another of the current schemes. Whether the product is worms, cassettes, sailboats, or chinchillas, the scheme is essentially the same. This particular scheme happens to be the subject of State v. George, 362 N.E. 2d 1223 (Ohio App. 1975). Again without going through the individual analysis outlined in Case A above, many of the same statutes can be made to apply, if the distributorships are sold by means of fraudulent representations or omissions. Further, because of the outlined controls imposed by Bonanza, there is clear possibility that the state anti-trust statutes would apply. Our purpose here is to show how this agreement is a security and also add a new possiblity, the use of the state franchise statutes.

(a) Securities Act

The court in the George case elected to consider the distributorships under the combined risk-capital-Howey test and concluded that the contract was an investment contract. There is little question that the first element is present here in the $7,000 investment made to purchase the distributorship. We must be careful here in determining what the common enterprise is. It is evident that the common enterprise here is the manufacture and marketing of prerecorded cassettes. Both the investor and Bonanza are interested in this common goal and do certain things to bring it about. For the combined test we must show that the $7,000 distributorship fee was used as a part of the capital of this enterprise. Evidence showed that the distributorship fees were used to pay the following items:

(1) bookkeeping fees in connection with the licensing agreements; (2) royalty payments, presumably for the right to use the music recorded on the tape; (3) advertising and sales management, again presumably in connection with the sale of the cassettes and possibly in the sale of the distributorships; and (4) payment for training of personnel in installation. Based upon these uses, the court's conclusion was that the investor's money was invested in the risk capital of the venture. The third element of the combined test, the expected benefit, is easy to find. Clearly, the investor entered into the agreement expecting to make a profit through the sale of the cassettes.

It is the last element of the combined test which is the most difficult to find. First, it is obvious that the investor has to perform some labor in assembling the cassettes. However, this is like the sweeping out of the store in the Hawaiian Market Center line of cases. This work is done under strict supervision of Bonanza. Bonanza makes all the decisions which are necessary to determine whether the profit will be realized. Bonanza selects the material which is recorded on tapes, trains all the investor's personnel in how to assemble the cassettes, and takes total responsibility for the marketing and shipping of the completed cassette. Thus while the investor determines the amount of potential profit he is entitled to by the number of cassettes he delivers to Bonanza, whether this profit will actually be realized is dependent upon Bonanza's complete handling of the other aspects of the common enterprise. Thus, I submit the court was correct in concluding that the defendant was guilty of selling unregistered securities in the form of investment contracts.

(b) <u>Franchise Act</u>

An alternative to controlling these business opportunities under the securities acts is to control them under the state franchise statutes. These statutes, which have been adopted in an increasing number of states, are often patterned after the securities act and require the registration of the franchise,

as well as the people selling them. Normally, they will contain an anti-fraud provision similar to that discussed in Section III.[29] Recently, the North Dakota authorities held that worm farms, which had been held to be securities in South Dakota and Iowa, were franchises under the North Dakota statute.

C. Case C--The Advanced-Fee Scheme

Since on or about March 1978, Jack McGovern, John Flynn, and John Knoblauch, have been doing business under the name Barclay Financial Group. The individuals and Barclay have been holding themselves out to the public to be money brokers, collecting an up-front fee in return for a contractual promise to a prospective borrower to provide an unidentified lender who would loan substantial moneys to the said prospective borrowers. Frequently, these borrowers are real estate promoters in need of money to complete various projects. For one reason or another, these borrowers are often unable to secure these necessary funds through normal banking or financial channels. In some cases, however, the borrowers are merely individuals in need of loans for various personal reasons. In connection with these contractual obligations, Barclay and the various individuals have led the persons approached to believe that if the loans are not made available by Barclay within a reasonable period of time, the advanced or up-front fee will be automatically refunded. This impression is in direct contravention of Paragraph E, Section 4 of the agreement between the parties and has never taken place, even though Barclay has as yet been unable to secure any loans. The individuals and Barclay have also failed to disclose that Jack McGovern as the agent for Western Capital Corporation was found by a South Dakota Court to have been engaged in deceptive trade practices in December 1977. Western Capital Corporation was engaged in an identical advanced-fee scheme.

1. Discussion

The facts in this case are a combination of those in United States v. Austin, 462 F. 2d 724 (10th Cir.), cert. denied 409 U.S. 1048 (1972) and the recent North Dakota case of Securities Commissioner v. McGovern, Civ. No. 27275 (N.D. Dist. Ct., Burleigh County, May 30, 1978). Again, the main purpose of this illustration is to point out that the securities act can be effective in controlling this type of scheme. However, as the reference to the injunction obtained under the South Dakota suggests, these schemes can also be attacked under the state deceptive-trade practices acts as discussed under Case A. See Commonwealth v. Hamilton, 3 Blue Sky L. Rep. ¶71,421 (Pa. C.P. March 15, 1978) where a blue-sky count was joined with a deceptive-trade practices count in a criminal case involving promissory notes. Further, we will introduce a California civil damages statute which also could be used in connection with the misstatements made in the case.

(a) Securities Act

The first problem is showing that the advanced-fee scheme involves the sale of a security. In both the Austin case and the North Dakota case, the court found that the advanced-fee scheme constituted an evidence of indebtedness. A similar conclusion was reached by the Alaskan Securities Department in In re Bailey, 3 blue Sky L. Rep. ¶71,176. As you should remember from our earlier discussion, the Austin court held that an evidence of indebtedness included all contractual obligations to pay in the future for money presently received. It is clear that Barclay enters into a written agreement with the persons seeking the loan. This constitutes the necessary contractual obligation. Further, it is clear that the borrowers pay for Barclay's commitment by paying the up-front or advanced fee. The only real question is whether Barclay's commitment is a promise to pay in the future. In Austin, as with Barclay, the person receiving the advanced-fee obligation is to find a third person willing to lend money. The court concluded that

such was sufficient to make the agreement an evidence of indebtedness because it was an enforceable obligation which contemplates the flow of funds. As we saw when discussing evidences of indebtedness, the fact that a promise is conditional will not prevent it from coming within the classification. In the case presented, the representation was made that the advanced fee would be returned if the loan was not forthcoming. This made the granting of the loan conditional but it did not prevent securities classification. Thus, the conditional promise to find someone to loan the money--a conditional promise contemplating the flow of funds--is sufficient.

Once it has been established that the advanced fee is a security, then a civil injunction or a criminal prosecution can be obtained because the advanced fee is not registered nor are the people engaged in the scheme registered as agents or broker-dealers. Further, the fact situation outlines one omission and one misstatement. Both the misrepresentation about the refund of the fee if no loan is forthcoming and the omission to reveal that one of the firm's principals had been enjoined under the deceptive trade practices provisions of a sister state in connection with an identical scheme are clearly material. Further, it should be quite obvious that at least the individual involved know of the injunction and all knew the terms of the written agreement which they were using. Therefore, again a civil injunction or criminal prosecution under the securities act for statements should be easy to obtain.

(b) General False-Advertising Statute

California has a general false-advertising statute. Cal. Business and Professional Code §17500, which in essence makes it unlawful in the disposition of real or personal property to make any statement concerning the property which is untrue or misleading where the untrue or misleading nature of the statement is known by the person making it or could have been discovered by the exercise of reasonable care. A violation of this provision can result in a civil penalty of up to $2,500

for each violation, and suit can be brought by the attorney general, district attorney, county counsel or city attorney. Because the standard here is only that of negligence, this type of statute also would be useful in controlling the type of misleading statements in our case. Note, however, that the statute does not cover the omissions of material fact. The securities act does; and therefore, the California authorities have joined enforcement efforts under this statute with enforcement efforts under the securities act in a number of cases. See, e.g., People v. Witzerman, 105 Cal. Rptr. 284 (Cal. App. 1972) involving cattle contracts.

## ENDNOTES

[1]A Ponzi Scheme is an operation in which an investor receives his profits not from the earnings of the enterprise, but from money invested by later investors. In a sense, it is like the typical chain letter scheme. It gets its name from Charles Ponzi who conducted a very successful scheme in Massachusetts in 1919.

[2]411 F. Supp. 818 (D. Ore. 1975).

[3]Section 2(1), 15 U.S.C. §77b(1) (1978).

[4]Uniform Securities Act, §401(1) (1957).

[5]United States v. Austin, 462 F. 2d 724 (10th Cir. 1972).

[6]King Commodity Co. v. State, 452 S.W. 2d 531 (Tex. Civ. App. 1974). For a discussion of the entire commodity option area, see, Long, The Naked Commodity Option Contract as a Security, 15 Wm. & Mary L. Rev. 211 (1973); Long, Commodity Options--Revisited, 25 Drake L. Rev. 75 (1976).

[7]328 U.S. 293 (1946).

[8]Murphy v. Dare to Be great, Inc., (1971-78 transfer binder).

[9]State v. Hawaii Market Centers, Inc., 485 P. 2d 105 (Haw. 1971). In these market center cases, the investors were offered memberships in a department store to be formed. The members were to pass out cards which would allow the card-holders to shop in the department stores. The member who passed out the cards would then receive a certain percentage of all the purchases made by the cardholder. This type of scam is beginning to reappear. Ohio, Kentucky, and Florida have all been hit by an operation known as Consumer Companies of America, or CCA. This company is merely operating a slightly revised version of the old membership game.

[10]Uniform Securities Act. §401(j)(3) (1957).

[11]Crowley v. Montgomery Ward, 570 F. 2d 877 (10th Cir. 1978).

[12]United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

[13]Commonwealth ex rel. Pa Sec. Comm. v. Consumer's Research Consultants, Inc., 414 Pa. 253, 199 A. 2d 428 (1964); Emery v. So-Soft, Inc., 199 N.E. 2d 120 (Ohio App. 1964).

[14]Silver Hills Country Club v. Sobieski, 361 P. 2d 096 (Cal. 1961).

[15]Jet Set Travel Club v. Corporation Commission, 535 P. 2d 109 (Ore. App. 1975). But see State ex rel. Park v. Glenn Turner Enterprises, Inc., (1971-78 transfer binder) Blue Sky L. Rep. §71,023 (Ida. Dist. Ct. 1972).

[16]State v. Hawaii Market Center, Inc., 485 P. 2d 105 (Haw. 1971).

[17]Uniform Securities Act, §407(a) (1957).

[18]Uniform Securities Act, §412(a) (1957).

[19]Uniform Securities Act, §408 (1957).

[20]Uniform Securities Act, §401(j) (2) (1957).

[21]Uniform Securities Act, §414 (1957).

[22]United States v. Austin, 462 F. 2d 724 (10th Cir. 1972); State v. Whiteaker, 247 P. 1077 (Ore. 1926); People v. McCalla, 220 P. 436 (Cal. App. 1923); Commonwealth v. Hoffman, 3 Blue Sky L. Rep. §71,426 (Pa. C.P., Cumberland County, 1978).

[23]Uniform Securities Act, § 402(d) (1957).

[24]State v. Whiteaker, 247 P. 1077 (Ore. 1926); People v. Clem, 114 Cal Rptr. 359 (Cal. App. 1974); United States. v. Anzelmo, 319 F. Supp. 119 (E.D. La. 1970). But see People v. Ferguson, 24 P.2d 965 (Cal. App. 1933).

[25]Curtis v. State, 118 S.E. 2d 264 (Ga. App. 1961); People v. Henning, 346 N.Y.S. 2d 370 (A.D. 2973).

[27]The statement of facts and most of the discussion in this case study is taken from Comment, Multi-level or Pyramid Sales Systems: Fraud and Free Enterprise, 18 S.D. L. Rev. 358 (1973) which lists and discusses most of the cases involving Glenn Turner, both reported and unreported.

[28]4 Economic Crime Digest (No. 2) 19 (1978).

[29]The sections of the North Dakota Act which are typical are reproduced in the Appendix.

## APPENDIX I

## UNIFORM SECURITIES ACT

### FRAUDULENT AND OTHER PROHIBITED PRACTICES

Section 101. *(Sales and Purchases.)* It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

### REGISTRATION OR BROKER-DEALERS, AGENTS, AND INVESTMENT ADVISERS

Section 201. *(Registration Requirement.)*

*(Broker-Dealers and Agents.)*

(a) It is unlawful for any person to transact business in this state as a broker-dealer or agent unless he is registered under this act.

### REGISTRATION OF SECURITIES

Section 301. *(Registration Requirement.)* It is unlawful for any person to offer or sell any security in this state unless (1) it is registered under this act or (2) the security or transaction is exempted under section 402.

## DEFINITIONS

<u>Section 401</u> * * *

*("Security.")*

(1) "Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed number of dollars either in a lump sum or periodically for life or some other specified period.

<u>Section 409</u>. *(Criminal Penalties.)*

*(Penalties Prescribed.)*

(a) Any person who willfully violates any provision of this act except section 404, or who willfully violates any rule or orde under this act, or who willfully violates section 404 knowing the statement made to be false or misleading in any material respect, shall upon conviction be fined not more than $5,000 or imprisoned not more than three years, or both; but no person may be imprisoned for the violation of any rule or order if he proves that he had no knowledge of the rule or order. (No indictment or information may be returned under this act more than five years after the alleged violation.)

*(Prosecuting Authority.)*

(b) The (Administrator) may refer such evidence as is available concerning violations of this act or of any rule or order hereunder to the (attorney general or the proper district attorney), who may, with or without such a reference, institute the appropriate criminal proceedings under this act.

*(Saving of Other Crimes.)*

(c) Nothing in this act limits the power of the state to punish any person for any conduct which constitutes a crime by statute or at common law.

1 Blue Sky Law Rep. ¶4901 (1977) shows that 35 states and territories have adopted the Uniform Securities Act in one form or another. These include: Alabama, Alaska, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, Pennsylvania, Puerto Rico, South Carolina, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. The remaining states all have securities acts whose provisions in most cases are very similar to the sections reproduced above.

APPENDIX II

NORTH DAKOTA FRANCHISE INVESTMENT ACT

N.D. CENTURY CODE CH. 51-19

Section 51-19-02

DEFINITIONS

* * * * *

5.a. "Franchise" means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(1) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and

(2) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trade-mark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and

(3) The franchisee is required to pay, directly or indirectly, a franchise fee.

b. Where used in this chapter, unless specifically stated otherwise, "franchise" includes "area franchise".

51-19-03. Registration of offer.--

It shall be unlawful for any person to offer or sell any franchise in this state unless the offer of the franchise has been registered under this chapter or exempted under section 51-19-04.

51-19-11. Fraudulent and prohibited practices.--

1. It shall be unlawful for any person knowingly to subscribe to or make or cause to be made any material false statements or representation in any application, financial statement, notice, report, or other document filed under any provision of this chapter or to omit to state any

material statement or fact in any such application, financial statement, notice, report, or document which is necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to fail to notify the commissioner of any material change as required under subsection 6 of section 51-19-07.

2. It shall be unlawful for any person in connection with the offer, sale, or purchase of any franchise, directly or indirectly:
   a. To employ any device, scheme, or artifice to defraud; or
   b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
   c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

3. It shall be unlawful for any person to violate any order of the commissioner or condition to the effectiveness of the registration of the offer or sale of franchises.

4. It shall be unlawful for any person to effect or attempt to effect a sale of a franchise in this state unless such person is identified in an application or amended application or prospectus filed with the commissioner.

5. It shall be unlawful for any person to represent or cause to be represented to any prospective purchaser of a franchise that the filing of any document under this chapter or the registration or exemption from registration of a franchise constitutes a finding by the commissioner that any document filed under this chapter is true, complete, and not misleading, or that the commissioner has passed in any way upon the merits of any franchise, or that a franchise is registered or exempted from registration when in fact such is not the case.

51-19-14. Criminal penalties.--

1. Any person who willfully violates any provision of this chapter or who willfully violates any rule or order under this chapter shall be guilty of a class B felony; but no person may be imprisoned for the violation of any rule or order if he proves that he had no knowledge of the rule or order.
2. Any person who willfully employs, directly or indirectly, any device, scheme, or artifice to defraud in connection with the offer or sale of any franchise or willfully engages, directly or indirectly, in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the offer, purchase, or sale of any franchise shall be guilty of a class B felony.
3. Nothing in this chapter limits the power of the state to punish any person for any conduct which constitutes a crime.

1. G. Glickmen, Franchising ¶2.01 (15 Matthew Bender, Bus. Organizations 1978) indicates that at least 18 states have general franchise statutes of one form or another. These include Arkansas, California, Delaware, Florida, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, North Dakota, Oregon, New Jersey, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Many other states have statutes covering special franchises such as automobile franchises.

# APPENDIX III

## CALIFORNIA GENERAL FALSE ADVERTISING STATUTE

Cal. Bus. & Prof. Code § 17500.

§ 17500. False or misleading statements. It is unlawful for any person, firm, corporation or association, or any employee thereof with intent directly or indirectly to dispose of real or personal property or to perform services, professional or otherwise, or anything of any nature whatsoever or to induce the public to enter into any obligation relating thereto, to make or disseminate or cause to be made or disseminated before the public in this State, in any newspaper or other publication, or any advertising device, or by public outcry or proclamation, or in any other manner or means whatever, any statement concerning such real or personal property or services, professional or otherwise, or concerning any circumstance or matter of fact connected with the proposed performance or disposition thereof, which is untrue or misleading, and which is known, or which by the exercise of reasonable care should be known, to be untrue or misleading, or for any such person, firm, or corporation to so make or disseminate or cause to be so made or disseminated any such statement as part of a plan or scheme with the intent not to sell such personal property or services, professional or otherwise, so advertised at the price stated therein, or as so advertised.

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